A1310-1.1 F

American Council for Capital Formation
Center for Policy Research

June 1989

SPECIAL REPORT

The U.S. Cost of Capital and Recent Tax Policy

The cost of capital in the United States today is considerably higher than in Japan, West Germany, and most of our other competitors--a situation that is of growing concern to economists and policymakers. Lower capital costs promote higher investment, which increases a nation's capital stock, provides more capital per worker, and results in greater productivity and growth in the standard of living. This special report focuses on how the U.S. compares internationally and how recent revisions to the federal tax code have affected U.S. capital costs.

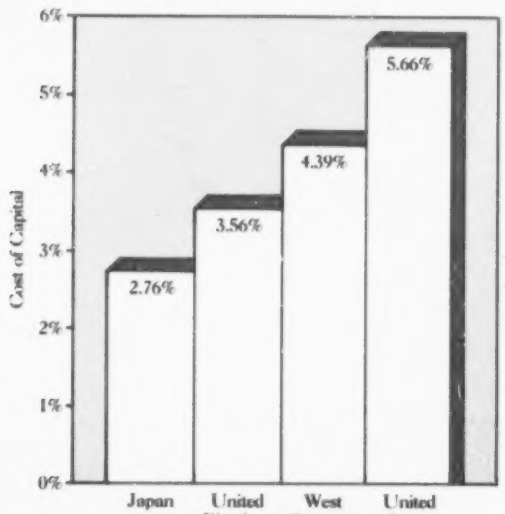
The Concept of Capital Costs

The cost of capital is the pretax return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, economic depreciation, and taxes. This capital cost concept is often called the user cost of capital or the "hurdle rate" because it measures the return an investment must yield before a firm would be willing to undertake the capital expenditure.

For example, for a typical manufacturing firm to be willing to purchase a new piece of equipment, given current tax law and economic conditions, the asset today would have to yield an annual return of approximately 22 percent. This yield would cover all costs, including the purchase price of the equipment, real (economic) depreciation, financing costs, and taxes.

Often a slightly different measure of the cost of capital, the pretax return required by an investor, is used. The only difference between the user cost (or "hurdle rate")

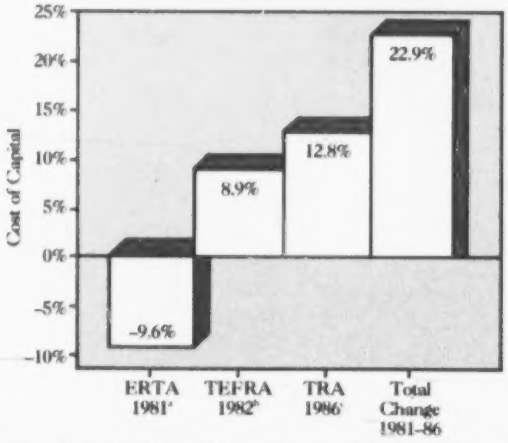
Chart 1: International Comparisons of the Cost of Capital



Source: B. Douglas Bernheim and John B. Shoven, "Taxation and the Cost of Capital: An International Comparison," in Charls E. Walker and Mark A. Bloomfield, eds., *The Consumption Tax: A Better Alternative?* (Cambridge, Mass., Ballinger Publishing Co., 1987). Chart prepared by the American Council for Capital Formation.

Note: Cost of capital for an average of debt and equity funds. The cost of capital measure used here is the pretax return required by an investor, which is net of economic depreciation.

Chart 2: Impact of U.S. Tax Code Revisions on the Cost of Capital for Equipment Used in Manufacturing (User Cost Basis)



Source: Congressional Research Service, Library of Congress, "Effects of Alternative Tax Regimes on the Cost of Capital for Selected Types of Equipment," February 1989 (unpublished). Chart prepared by the American Council for Capital Formation.

Note: The cost of capital measure used here is the user cost, which includes economic depreciation.

[a]The Economic Recovery Tax Act of 1981 (ERTA) reduced rates compared to prior law.

[b]The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced ERTA's investment incentives.

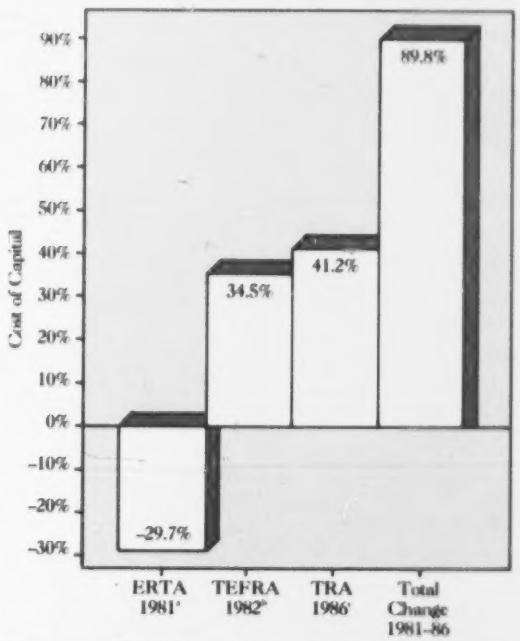
[c]The Tax Reform Act of 1986 (TRA) further reduced the investment incentives available under TEFRA and raised effective tax rates to a level higher than that prevailing in 1980.

and the pretax return measure is that the former includes economic depreciation (about 15 percent per year for equipment, for example). Economic depreciation, which measures the actual useful life of the asset, does not vary with the tax code.

International Comparisons

International comparisons based on the pretax return cost of capital measure show that the cost of capital for equipment in the United States is 5.66, compared with 2.76 in Japan—a difference of more than 100 percent. The U.S. cost of capital also exceeds the United Kingdom's 3.56 percent and West Germany's 4.39 percent. The most significant factors contributing to variations in capital costs among countries are differences in real interest rates and tax codes (see chart 1).

Chart 3: Impact of U.S. Tax Code Revisions on the Cost of Capital for Equipment Used in Manufacturing (Pretax Return Basis)



Source: Congressional Research Service, Library of Congress, "Effects of Alternative Tax Regimes on the Cost of Capital for Selected Types of Equipment," February 1989 (unpublished). Chart prepared by the American Council for Capital Formation.

Note: The capital cost used here is the pretax return required by an investor, which is net of economic depreciation.

[a]The Economic Recovery Tax Act of 1981 (ERTA) reduced rates compared to prior law.

[b]The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced ERTA's investment incentives.

[c]The Tax Reform Act of 1986 (TRA) further reduced the investment incentives available under TEFRA and raised effective tax rates to a level higher than that prevailing in 1980.

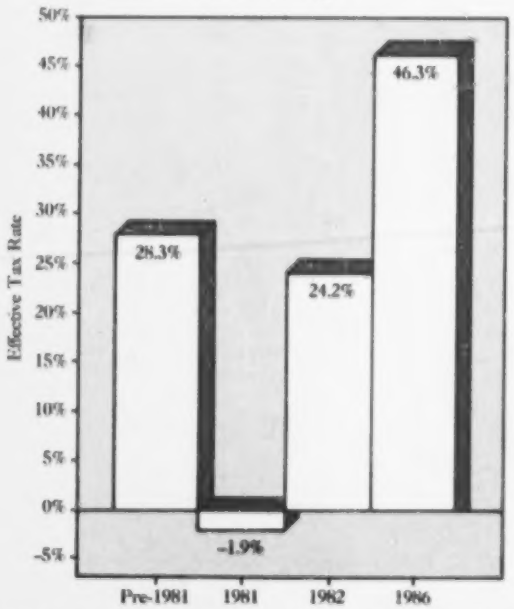
The most serious consequence of high U.S. capital costs is that productivity growth is impeded. Fiscal policy experts agree that U.S. productivity growth has lagged, in part because our investment per worker has been much lower than that of many of our competitors.

Recent U.S. Tax Policy

Federal tax policy was responsible for increasing the user cost of capital for equipment in the United States by about 23 percent from 1981 to 1986 (see chart 2). Capital costs (measured as the pretax return required by an investor) rose almost 90 percent during this period (see chart 3). Effective tax rates on new investment reflect capital costs. After the passage of the Economic Recovery Tax Act of 1981 (ERTA), the tax rate on equipment approximated expensing; by 1986 when the Tax Reform Act was enacted, the rate increased to 46.3 percent—which exceeds the statutory rate of 34 percent (see chart 4).

A major factor contributing to an effective tax rate of 46.3 percent is the lack of indexing for depreciation and for interest income and expenses. Such tax policies can and must be reversed in order to bring U.S. capital costs more in line with those of our major competitors.

Chart 4: Effective Tax Rates on Equipment Used in Manufacturing



Source: Congressional Research Service, Library of Congress, "Effects of Alternative Tax Regimes on the Cost of Capital for Selected Types of Equipment," February 1989 (unpublished). Chart prepared by the American Council for Capital Formation.

The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to promote an understanding by the public of the importance of capital formation to the economy. For additional information please contact: ACCF Center for Policy Research, 1850 K Street, N.W., Suite 400, Washington D.C., 20006, (202) 293-5811.